Breakouts, Stops and Chart Patterns

Breakouts

Many investors find trouble buying upward breakouts on charts. Their complaint is often framed that false breakouts have been very damaging to their investing results.

My immediate response it to be a pedant for a moment on an issue that I think is important. I do not believe that a breakout can be somehow false; there is either a breakout or there is not a breakout. Assuming the most generally agreed definition of an upward breakout is a transaction at a price above the highs of whatever pattern we are looking at, the price either broke above those highs – a real breakout – or it did not.

The only issue may be how far the price must move above the high of the pattern for it to be defined as a breakout. Further, some analysts may also define a breakout as needing to close above the high of the pattern. If the move above the high of the pattern does not meet those conditions, then it might be seen as not being a breakout. However, if a move does not meet the definition of a breakout it is simply not a breakout, not a *false* breakout.

This is important because I think what is usually meant by *false* here is that the breakout was an *unsuccessful or failed* breakout. This is a totally different thing. Some breakouts succeed. An upward trend develops. Other breakouts do not succeed. The price falls back through the pattern and out the other side of the pattern in a downward trend. In between, are failed breakouts that drop back into the pattern and the pattern continues to develop for a future breakout to occur in either an upward or downward direction.

However, there is an important observation we can make about breakouts. In a strong bull market, particularly in its early and middle stages, a high proportion of breakouts will tend to lead to an upward trend of varying extent. Towards the end of the bull market, or in a bear market, a much higher proportion of upward breakouts will tend to fail to lead to an uptrend. I have no trouble with this, because it is normal and it is an important piece of information. It tells me something valuable, namely that I need to be somewhat more selective and careful about breakouts and to expect more of them to fail than in better conditions.

Stops

All investors at some time come to the realisation that stops are a critical element in the preservation of investment capital. However, where they become frustrated is that they spend a lot of time fruitlessly trying to optimise their stops in some way. Eventually they come to the conclusion that there is no way to optimise stops.

When these investors talk of optimising stops, they mean that the stops are perfect; that they take them out of every losing investment cheaply and keep them in every winning investment right to near the end of the trend.

This realisation that stops cannot be optimised or perfect is a very profound conclusion in the journey from beginner to good investor. Raw beginners are usually still looking for the Holy Grail – a method of investing that works every time. In reality, this level of perfection is quite impossible. All investing involves losses and also it involves some premature stops. That is the nature of investing, which involves the management of risk in an unpredictable market. When the trend is strong, our batting average is higher than when the trend is weak or fickle and turns against us quite quickly.

Distance of Stop from Breakout

A problem that is commonly put to me is that buying a breakout from an accumulation pattern is that a stop under the lows of the pattern is a long way away from the buying price and therefore costly when the breakout fails.

I could not disagree with a statement more than with this one. In my book *Building Wealth in the Stock Market* (previously published as *The Aggressive Investor*), I go to some lengths to explain how to calculate the position size for an investment so that no matter how far away in cents the stop level is, I always risk up to the same percentage of my capital.

I never, ever, risk more than 0.5% of my capital on an investment of 2% of capital. So, if the stop is 10c away, my rule would allow me to buy more shares than if the stop was $1 away. The whole point is that I am quite indifferent to how far away my stop is from my buy price – I am always risking up to the same percentage of my capital. Therefore, if my capital is $100,000, and my maximum risk is 0.5%, both the 10c stop and the $1 stop would be risking no more than $500 in total.

I cannot emphasise this enough. It is absolutely basic to becoming a good investor and the comment from so many investors indicates that they have not yet internalised this issue. When each investor completely understands and accepts it, they will be able to move to the next level on their climb to investment expertise.

Under Pressure

Many beginners find it is emotionally very taxing waiting for the stop signal to be triggered under these conditions. Again, this is an expression of where they are on the journey towards internalising that the risk in percentage of capital is the same no matter how far away the stop is in dollar terms. Sure, there is emotional pressure when an investment is under water, but it should be no different, no matter where the stop is, because your risk should always be the same total dollar amount.

Tighter Stops not the Answer

The natural, though illogical, reaction is that tighter stops only throw the beginner out of good investments prematurely. If we have an investment plan, which has been thoroughly tested and indicates where the most effective place is to set our stops based on the logic of our plan, then if we move the stops any closer, a normal movement in prices will stop us out prematurely and maybe at a loss. The whole idea of tightening stops is a big mistake in investing - assuming that we have tested our method and it works a good proportion of the time. The key to the use of stops is to cut losses quickly, but let good investments build returns.

Professionals Pick Off Our Stops

I very common complaint from beginners is that “the professionals” know where the typical investor's stops are and deliberately trigger them to sucker them into or out of a position.

Of course this is true, but not only of “professionals”, term used like “they” all the time. Don’t you also know where most stops will be? I do, give or take a cent or two. The use of the description “professionals” suggests to me that the beginners making this complaint have a bit of a complex about it. I would re-phrase it and say that all experienced investors have a good idea where the majority of stops will be. They are not deliberately out to get us, except to the extent that they are taking advantage of we put our stops in an obvious place that represents an opportunity to profit by triggering them.

So, it makes perfect sense for experienced investors to sell a stock down to where the stops are likely to be and then buy as the stops become sell orders. This is a good way to get set at prices just under a pattern or support level. This is the reason why support levels are not that precise. There is some level of overshooting or undershooting at all times. So, a stop should not be too close to the absolute low of the old support level. Having stops too close is not protecting capital, but leaving us open to consistent losses.

Now put yourself in the shoes of the experienced investor. They buy a position. Why would they put their stop where everyone else does and where any other experienced investor will know where to trigger them if they want to? The experienced investor will put their stop below that level, so the chances of it being hit are reduced, but the stop still protects them from a failure of the investment. In other words, stops should be sufficiently far below the obvious range for stops, so that if the price falls there, it clearly indicates that the breakout has failed and the trend has gone into reverse.

Strength of the Breakout

Something I do that is counter-intuitive to most beginners is worth a few words here. The stronger the breakout move the happier I am to join it. Most beginners will not chase rising prices, however that is the time when I am most confident that I may be onto a good one. A share that has broken out and is continuing to rise is much stronger than one that breaks out and then hovers. There is one situation where I will wait. If the price breaks out and then retreats into the pattern, I will tend to wait for a confirming second breakout.

Phased Entry

My initial entries on breakouts are:

Value model charts: after an accumulation phase breakout.

Growth model charts: after a consolidation phase breakout.

After that, I buy more on the pullback to support and complete building the investment on the next move above the peak following the breakout. In other words, I buy in expectation of a trend and build the position as the trend is confirmed.

This is a very important part of my risk management. A breakout should lead to a trend on my models, but sometimes that does not happen for many reasons. Phasing my entry as the trend I expect actually unfolds means that when a trend fails, my loss is much smaller than had I jumped in boots and all at the breakout.

Quite separately, I find that with both value model and growth model stocks, for all sorts of reasons, I may not take a breakout entry. I will then consider entering the uptrend. Again, I have a three-stage entry tactic, which is explained in detail in *Building Wealth in the Stock Market*: I buy a new high above the last peak, build the position on a pullback and complete building it on the next new high above the last peak.

Low or Closing Price?

In executing my sops, I act on the intraday low rather than the closing price. In *Building Wealth in the Stock Market* I described my definition of a trend and my two models that I use to choose when to buy and when to sell, or be stopped out.

My trend definition is that each trough in the trend is higher than the last one. If a trough is taken out by any price – open, low, close or intraday, then the trend is no longer intact by definition. This is what I mean by the logic of my investment plan. So, I will sell as soon as I am aware of the stop being hit – same day, next day, whenever. Sometimes my exit price will be below my stop, sometimes it is above it and even above the last trough. As I said, the trend is no longer intact, so I am out of there.

The fundamentals have absolutely zero role in this decision to execute a stop. I use the fundamentals to select stocks to invest in, but all timing decisions are made totally on the chart evidence. Fundamentals can be used as a crutch to rationalise not taking a chart signal. This is very seductive and highly injurious to your account. Stops are there to control risk. They must be executed without hesitation.

However, one of the hazards of investing in smaller, thinly traded stocks is not the experienced investors – they will not bother with these stocks unless they are a micro-cap fund or investor – but the inexperienced small investors who use automatic stop loss levels in stocks that are unsuitable for that method. Stop-losses are meant for deep liquid stocks. On thinly traded stocks, one triggered stop-loss order can trigger a whole cascade of others. That is one reason so many beginners lose, by the way. It is unfortunate that this happens, but that is life. I move on and consider re-entry if the trend reasserts itself later.

Can Anyone Follow My Investment Plan?

The short answer is an emphatic no!

Everyone is different and has to develop their own investment plan that fits comfortably with their temperament, risk tolerance, knowledge and experience. I wrote up my investment plan to provide a model of what should be in a plan, but each reader needs to vary it to suit who they are and where they have come from. It will take up to ten years to reach the point where they have enough knowledge and experience to do that and be comfortable with it. I cannot emphasise enough that I am not expecting many readers to just adopt my plan without any modification to some elements. If they try, they will probably fail, because they are not me and do not have my experience.

An even more important reason is that to be successful, an investor cannot avoid the serious contemplation of the issues and the testing of them until they have grown confident in their approach. None of us ever stops thinking and learning. Some things that I am comfortable with, I have thought deeply about later and become even more confident of my conclusions.

The issue of my feel for the market is critical. That is called experience. It takes time at the coalface over a long time and requires a lot of post mortem assessment, research and modification. One of the problems in writing up my investment plan in *Building Wealth in the Stock Market* was to try my best to get down everything I was doing. It took a long time and the process I used was to teach seminars where I fielded questions that probed everything I do. There may be some things I could have explained better. There may be some really minor things I left out, but nothing that is really material.

I often explain that I can teach knowledge and hope I am good at it, but I cannot teach my experience. It is the nature of experience that we have to have made the journey and thought it out as and after we go there. Experience and deep contemplation gives confidence and the result is almost automatic execution of the plan without emotion getting in the way. Decisions lose their emotional content – win or lose they are simply coldly logical business decisions. I am sorry therefore to tell beginners that they are going to have to make the experience journey. Otherwise, they will not have the confidence to execute their plan under the intense pressure the market puts us all under. They will tend to try to rethink the plan at the worst time. It is a recipe for losses.

My best advice is to take it slowly. Develop a plan. Test it on past data and going forward on paper in real time. Then make one investment and complete it before making another. When you have a good track record, think about making more than one investment at a time. The key advice is not to lose too much money while you are learning. An apprentice surgeon learns the same way – he or she tries very hard not to lose or damage too many patients in the learning process.

Reliability of Chart Patterns and Their Use

Price patterns are a broad subject and, to some extent, what is meant depends on our definition of a pattern.

There are two large groups of patterns:

One is the general area of reversal and continuation patterns. These can be very large patterns on weekly and monthly charts. They can also be shorter-term patterns on daily or intra-day data charts. However, in their time frame they have essentially the same use.

The other general area is short-term price patterns that comprise only a few bars, such as a key reversal day or an open-close reversal. These can also be used in various time frames, so that you can see them on daily, weekly and monthly charts. Candlestick charting also has a range of these patterns.

There are also unique patterns in point and figure charting, Market Profile and Elliott Wave Theory.

Patterns are important because they help us to understand what is happening in the interplay of buyers and investors. This is particularly so when a pattern shows us that the supply and demand balance may be changing. Some people use the simplistic approach of memorising the patterns and try to then interpret them mechanically. This can be a useful place to start, but is really not, in my experience, all that helpful. What is far more useful is an understanding of what the pattern is telling us and in being able to see subtle differences in each situation. Seeing what everyone else sees gives little opportunity to be ahead of the crowd. Being able to see and understand aspects of the pattern, that others have not taken the time and made the intellectual effort to analyse, can be very valuable. The difference between these two approaches is what differentiates a beginner from an experienced analyst.

However, thus far I have only spoken about analysts. Analysts are people who spend a lot of time trying to understand any situation and who are usually paid to have a view one way or the other on any chart.

An investor has a different objective altogether. An analyst seeks to be right about almost every situation. An investor is seeking only to make a return from a portfolio of stock. An investor knows they cannot be successful with every stock they buy for their portfolio and don't expect to be. What they do try to achieve though is a good net return over a period of time and series of transactions that makes up their portfolio as they fine-tune it over time.

An investor therefore comes at chart patterns very differently to an analyst. They seek to exploit a small number of set-ups. When they don't see the set-up on the chart, they leave it for analysts to deal with for their purposes. Then, when they do see the set-up they are looking for, they consider acting on it as set out in their investment plan, assuming there is a margin of safety in the situation. So, an investor has a totally different approach to chart patterns, with a different objective and different expectation of the outcome from an analyst.

Of course, many private investors need to be part analyst and part investor. This is because they do not have the luxury or scale to separate these two different functions and give the two roles to different people. Where private investors get into difficulty is that they often fail to see the two separate activities they are carrying out. They mix them up. They try to be two partially incompatible things at the same time. An investor might not give a chart a second glance. An analyst may spend hours on it. The investor is looking for opportunities. The analyst is looking to make accurate comment on any situation. Private investors need, if possible, to have a very clear idea of what they are about. A good investor will have little time for detailed, difficult and often arcane analysis. They cut to the chase – if the opportunity is not there, forget it and move on to the next chart. This requires great patience and discipline, but is what separates the good investors from those who do not understand what they should be trying to do.

As an investor I do not really use chart patterns when making my investment decisions. I generalise. I am looking for accumulation patterns (value model) and consolidation patterns (growth model).

They are both essentially similar in shape – sideways price action over a year and often much longer. What is more important is what has led up to them, so that I can distinguish them from likely distribution patterns (both models). However, that is easier to do for the value model than the growth model.

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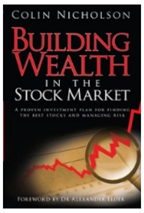

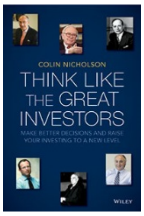

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